POSITION PAPER

ESBG Common Response to the EBA Consultation on guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)

October 2014

Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA consultation on *guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP GL)*. Below you will find our input to the consultation.

1. General Comments

Generally ESBG agrees on the need of harmonising SREP methodologies and practices, and we welcome the EBA's efforts to achieve this. Guidelines from the EBA will be a crucial element to ensure alignment of SREP practices across Europe.

The draft guidelines cover many important areas which must be taken into consideration when carrying out SREP. However, we miss the EBA's considerations on some very important issues; namely the practice for disclosure of authorities' conclusions after finalised SREP. Also, if establishing a common EEA-wide "scoring system" for authorities view on the robustness and/or sustainability of individual institutions, there must be clear guidance on the sharing of "scores" between authorities, to make sure that scores are held confidential. A prerequisite for the scoring model would else be that supervisors are ready to cope with their scores being interpreted as public ratings.

According to ESBG's opinion the categorisation of institutions into four categories does not provide sufficient granularity. We consider that having only four categories of institutions is too narrow and would not take the substantial differences between the institutions adequately into consideration. This is why we would suggest introducing at least five categories. Furthermore, we fear that in the current proposal it is rather unrealistic for institutions to be scored with a "1". Perhaps the scoring system should be amended to an extent that institutions will not overwhelmingly be scored with a "2" or "3", but also have realistic chances to be scored with a "1". Finally, the score needs to be awarded on the basis of an overall assessment. For instance, the partial use of capital buffers should not automatically mean that an institution is assessed with a "3".

ESBG also calls on EBA to strengthen the relationship between the supervisor and the financial institution when carrying out the SREP analysis – as was the case with the Committee of European Banking Supervisors (CEBS) guidelines No. 39. In particular, ESBG believes that within Pillar 2 it is important that supervisory authorities hold an extensive dialogue with the supervised institution so as to better understand the particular characteristics of the institutions. In our view, SREP is best conducted by incorporating both top-down as well as bottom-up elements. A comprehensive picture of an institution's risk management can only be achieved by a dialogue between supervisor and supervised institution.

In addition, ESBG strongly suggests recognising diversification effects. CRD IV clearly states in Article 98 that competent authorities should consider, among other things, the impact of diversification effects. We believe that a complete exclusion of diversification effects hugely overstates risks. The EBA should maintain incentives to build a well-diversified portfolio in the GL.

With regard to the assessment of credit risk concentration, ESBG points out that the EBA could not only consider the use of the Herfindahl Hirschmann Index (HHI) and Gini coefficients, but also other more sophisticated models that could be used to measure risk concentration (e.g. economic capital models).

The establishment of a common reporting framework for prospective exercises, such as the Internal Capital Adequacy Assessment Process (ICAAP), Internal Liquidity Adequacy Assessment Process (ILAAP), Stress Testing, Funding Plans and SREP exercises is of utmost significance. It is especially important to establish common criteria for consolidation perimeters, segmentation of both balance sheet and P&L items, time horizons of the exercises and coherence of levels of detail required. Moreover, more coordination regarding agendas and reference dates would be highly welcomed in order not to end up in a continuous process of planning and conciliation of the different prospective plans. In such a situation the administrative burden for the entities would be inappropriate in comparison to the value added for the regulator. Instead, duplicative and redundant data requirements should be avoided. The "Paperwork Reduction Act" in the US, where commonly used and stable templates were defined (e.g. FR-Y14 for CCAR,) might serve as an example of such an initiative.

In relation to the time horizons, we consider appropriate if the SREP and the stress testing exercise could be done in parallel to allow reconciliation between them. This would help to have more robust exercises as well as it would facilitate the communication of the results to the management's bodies of the entity.

In addition, we understand that the GL describe how supervisors should conduct a SREP, but neither how institutions should organise their ICAAP, nor how and when they should provide their supervisors with information on their ICAAP.

In several parts of the GL one can find the formulation "if available". However, it is never indicated what to do in the context of the SREP if the data and information is not available. We assume that institutions will not be disadvantaged solely on the grounds of unavailable, non-obligatory data.

In order to avoid confusion, the EBA could consider categorising the institutions in the classes A-D, and not – equally to the scoring – in classes 1-4.

In the context of the SREP GL, higher capital requirements in pillar 1 should only be considered if exceptionally high risks can be identified in a banking institution.

2. **<u>EBA Question No 1</u>: *Do the guidelines specify the SREP process sufficiently? Are there areas where the EBA should aim for greater harmonisation, or where more flexibility would be appropriate?***

It is crucial to establish a consistent and well developed framework for the SREP within the EU member states. At the same time, it must not be forgotten to take into account the necessary degree of flexibility as well as the principle of proportionality[1].

[1] The principle of proportionality will be dealt with in greater detail under point No 3.

Further clarification and more guidance would be needed in the subsequent areas:

In relation to an institution's adherence to the requirements and standards of good internal governance and risk control arrangements (point 77), it would be important to know how NCAs should take this aspect into consideration and how an institution's adherence to international standards is going to be assessed (e.g. Enterprise Risk Management – COSO).

With regards to the overall internal governance framework ESBG considers that there should be a definition of or criteria for the evaluation of a robust and transparent organisational structure. We also believe that the fact that the internal governance framework should be transparent to stakeholders needs clarification.

Furthermore, it might be necessary having more elements to assess and demonstrate that the management body knows and understands the operational structure of the institution ("*know-your-structure principle*").

It is also not entirely clear what exactly is meant by "management body" and "senior management body". Further clarification would be very helpful, particularly against the background that Anglo-Saxon business systems are often different from other European business and management structures. In any case, the GL should explicitly address the presence of both monistic (one-tier boards) and dualistic (two-tier boards) systems across Europe.

The SREP GL also establish that the national competent authorities (NCA) should pay close attention to atypical performance compared to peers by conducting peer analyses and benchmark calculations (for instance, in respect of Business Model Analyses). This requires more or less objective standards in each part of the specific assessment of an institution. However, there are doubts that objectiveness and comparability can always be guaranteed. Hence, ESBG believes that the use of peer-group analyses and benchmark calculations might not be appropriate if the peer groups do, for instance, not reflect the individual institutions' operating environment (geography, segments, etc.). More details on the determination of benchmarks and the categorisation into certain peer groups would also be needed to be communicated to the institutions in advance.

Moreover, it would be very helpful if the EBA could clarify whether the outsourcing policy should be evaluated in relation to an institution's business in general or only for essential activities or the core business and how a sound corporate and risk control would be evaluated (points 81-83).

The EBA could consider specifying how the NCAs should assess whether an effective interaction between the management and the supervisory functions of the management body exist and mention cases in which this interaction is needed (point 84).

In ESBG's opinion, the NCAs' assessment of internal governance should not only be based on EBA GL on internal governance and EBA GL on the suitability of members of management body and key functions, but it should also be aligned with the publication of EBA GL on the definition of the notion of sufficient time of commitment, the notion of adequate collective knowledge and experience (Art. 91(12), Directive 2013/36/EU).

It might also be considered to clarify the required level of formalisation of the internal control framework (point 101 b).

The NCA's assessment of the application at the consolidated level and implications for entities of the group do not explicitly say whether this aspect will be taken into consideration for the scoring (point 105).

Finally, ESBG doubts that the criterion called "corporate culture" should be part of the scoring since there is no common definition of this term and it is indeed very difficult to assess it in an objective manner.

3. **EBA Question No 2**: ***Do you agree with the proportionate approach to the application of the SREP to different categories of institutions?***

Proportionality is a crucial element to be followed in the establishment of the SREP GL: In the past, good and efficient supervision has always been linked to proportional supervisory principles. Bearing mind the need for a consistent and coherent regulatory framework, in pillar 2, principle-based approaches have often proven to be more suitable than rule-based approaches as the former can easier adapt to all different types of banking institutions. It is to be feared that rule-based approaches might lead to regulatory gaps, which would be beneficial to some institutions (lower capital requirements), but also unfavourable to many other institutions (higher capital requirements). The very diverse banking sector in Europe calls for proportionality and a principle-based approach in order that all institutions, having different business models and risk profiles, are covered in an appropriate way by one common supervisory framework, namely the SREP GL.

It is clear that more consistency in the supervisory methods across Europe needs to be achieved. However, more consistency should at the same time not impose restrictions on the management bodies by establishing too detailed rules. It might be dangerous that a too uniform and rule-based framework leads to having very similar institutions, which could finally increase systemic risks and procyclical effects.

Moreover, it is important that the size and the complexity of banking institutions are appropriately taken into consideration when establishing the SREP GL. Retail-oriented institutions should not be pushed too hard with e.g. documentation requirements, but rather be treated in suitable accordance with the principle of proportionality.

In general, ESBG fears that the SREP GL will contribute to the fact that supervision becomes more expensive, in particular for those institutions which are not directly supervised by the ECB. In this connection, some estimations and conclusions of the draft-cost-benefit analysis (section 5.1) are not entirely comprehensible to us.

In conclusion, ESBG very much appreciates that the principle of proportionality has been considered in various parts of the draft SREP GL. However, we feel that the proportionality principle could also become a lot more visible in some sections of the GL.

4. **<u>EBA Question No 3</u>: *Are there other drivers' of business model/strategy success and failure that you believe competent authorities should consider when conducting the BMA?***

In general, the SREP GL will introduce many more competences for the supervisory bodies. They will gain several additional powers to intervene. It is crucial to strike the right balance. In this regard, ESBG would like to emphasise that the NCAs' competence to conduct a BMA should not lead to the result that they end up having a say in the institutions' business policy. Supervisors should not take responsibility for the institutions' business policies – this shall rather remain a task of the institutions' management bodies. The scoring of business model and strategy should therefore be left out or used only as support when considering the other SREP components and proportionality.

ESBG understands that the business model analysis focuses essentially on the short term. The methodology proposes to assess the viability of a business model by its ability to generate acceptable returns over the following 12 months. However, this approach, which is overly sensitive to cyclical effects, may tend to produce procyclical assessments. A preferable alternative might be to jointly assess viability and sustainability of a business model and an institution's strategy on the basis of its capacity to generate acceptable returns over the medium term. The assessment should be made based on the likely trajectory of profitability/solvency/risk over the current year and the following 3-4 years. By the end of this projection period, cyclical effects should not be expected to play a significant role in the results.

In point 59a, "materiality of business lines" shall be defined by their strategic importance, no matter how profitable these business lines are. Strategic importance is not only measured in terms of profit/loss generation.

The "considerations" in point 76 might result in institutions following universal banking models having better scores than specialised institutions. In order to be scored with a "1", no "material asset and funding concentrations" are allowed. ESBG sees this statement fairly critical as specialised institutions often offer services of higher quality due to their degree of specialisation. At the same time they can definitely have an excellent business model. As a consequence, ESBG suggests introducing the element of specialisation in the "considerations" in point 76.

5. **<u>EBA Question No 4</u>: *Does the breakdown of risk categories and sub-categories proposed provide appropriate coverage and scope for conducting supervisory risk assessments?***

In several sections, the SREP GL establish the need for the NCAs to review risk concentrations (bond portfolio, deposit accounts, etc.). It would be necessary to clarify whether supervisors, when measuring Interest Rate Risk in the Banking Book (IRRBB), will analyse concentrations apart from accumulations of re-pricing/maturity at different points on the curve that determine interest rate risk (points 288-304). If the NCAs evaluated concentrations in fixed-income portfolios in the IRRBB risk assessment and product concentrations (e.g. deposits), this would not be evaluating IRRBB risk, but rather evaluating credit risk, business risk or liquidity. Therefore, we believe that the EBA should consider providing definition of concentration risk in the area of interest rate risk.

Concerning the IRRBB itself, ESBG calls on the EBA to deal with this topic in the specific guidelines on the IRRBB which are being developed by the EBA. Nevertheless, ESBG would like to highlight that in the current interest rate environment, a 200 basis points shock as proposed by EBA in point 293 of the consultation paper, is not necessarily tailored to all circumstances and rate environments, and therefore it would be more suitable to change the wording of +/- 200 basis point for "standard shock".

ESBG strongly believes that it would be better to continue to allow for the use of the internal model approach. On the metrics debate, ESBG supports that the importance of both the earnings as well as the economic value approach should be recognised in any future regime. The choice of the metrics should be consistent with the risk management strategy and risk appetite of the institution.

To ESBG's mind, the subcategories listed in point 244 are contradictory to the Advanced Measurement Approach (AMA)-categorisation. For instance, conduct risk does not play a role in the AMA-categorisation.

It is indeed difficult to compare IT-systems and IT-architectures among banking institutions as there are no harmonised standards to measure their complexity. Thus, if IT-complexity is included in the SREP GL, common and comprehensive assessment criteria will be more than useful.

There is no need to have reputational risk as a separate category. As reputational risk is regularly considered a part of operational risk, it should be treated as such within the SREP GL.

ESBG doubts whether it is necessary to differentiate between the 4 different types of risk in point 280. This might be a suitable theoretical approach. In practice, however, these risks are usually not dealt with in a separate way.

6. **EBA Question No 5**: ***Do you agree with the use of a standard approach for the articulation of additional own funds requirements to be used by competent authorities across the Union?***

As originally intended by the Basel Committee of Banking Supervision, pillar 2 of the Basel framework serves to acknowledge and evaluate institutions' own risk assessments and their corresponding allocation of internal capital. This reasoning has been adapted throughout the implementation of Basel II and Basel III by the European Union. ESBG believes that a standard approach is difficult to align with the CRD IV's and the Basel framework's understanding of pillar 2. Under the proposed standard approach for the assessment of an institution's capital adequacy and for the articulation of additional own funds requirements, pillar 2 as such would cease to exist and be replaced by a "pillar 1+" or "pillar 2A" perspective. We strongly believe that institutions should not be restricted to formal own funds definitions within pillar 2. In our view and in line with the Basel framework, institutions should be allowed to allocate internal capital as long as both its economic ability to absorb losses and its availability in a going-concern situation are ensured. ESBG therefore pleads for maintaining the original and internationally agreed upon definition of pillar 2.

More precisely, as we understand it, the new approach would require a comparison per risk between the pillar 1 capital charges, the capital requirement calculated using the bank's internal risk model and an amount calculated using a prudential benchmark model. We presume that the highest of these three amounts would be taken as a (worst-case) yardstick. If it was above the pillar 1 capital charge, an add-on for the difference would be imposed. These additional capital requirements for credit risk, market risk and operational risk would be added together and then further supplemented with a capital requirement for interest rate risk, model risk and reputational risk. No diversification effects would be taken into account. The objective of this exercise would be to calculate the worst possible overall risk scenario facing the bank. We do not believe that this would be a viable approach suitable for the management of a bank. Pillar 2 would be diverted from its intended purpose and downgraded to a "pillar 1 plus".

We consider a more appropriate approach that the bank calculates its overall need for economic capital (taking into account diversification effect) and to discuss the outcome with supervisors. Then the results of this process must be compared with the overall capital requirements determined under pillar 1. This approach is already in place in a couple of EU countries.

Specifically, the CRD IV explicitly uses the term "internal capital" (Article 73), while the SREP GL apply the term "regulatory own funds" to pillar 2. While article 104 (1a) CRD IV gives competent authorities the power to determine additional own funds requirements, we construe this power to be restricted to singular cases only. In other words, article 104 (1a) CRD IV does not affect the internal capital definition of article 73. In summary, the proposed limitation to own funds is not in line with the CRD IV's internal capital definition and point 337 should be amended accordingly.

In ESBG's opinion it is not necessary to also include credit concentration risk in point 335b as it is already part of the internal models determining credit risk.

With regard to point 320, ESBG would like to state that comparability of institutions in the context of ICAAP will not always be possible. For instance, there are differences in the parameterisation of the risk calculation concerning the risk capacity as "going concern" (in contrast to a "gone concern" approach).

Moreover, the additional capital requirements should not be determined by simply adding the capital needs of each risk category without allowing for diversification.

7. **EBA Question No 6**: ***Do you agree that competent authorities should be granted additional transition periods for meeting certain capital and liquidity provisions in the guidelines?***

Yes, ESBG strongly supports the idea that additional transition periods are granted to the competent authorities. Longer transition periods should be granted not only for the specified capital and liquidity provisions, but in general, as the guidelines will trigger significant implementation processes for both NCAs and supervised institutions.

About WSBI-ESBG (European Savings and Retail Banking Group)

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,300 billion, non-bank deposits of €3,480 billion and non-bank loans of €3,950 billion (31 December 2012).

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